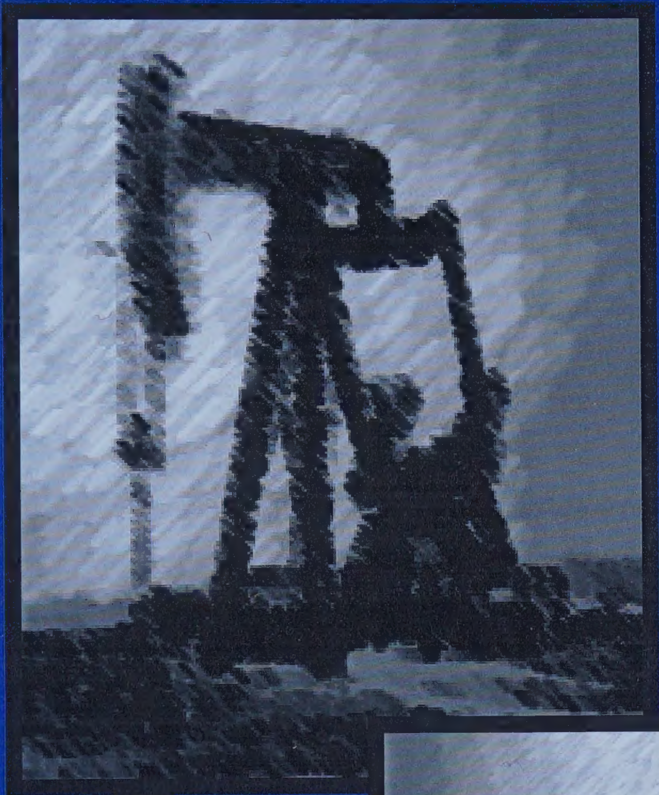
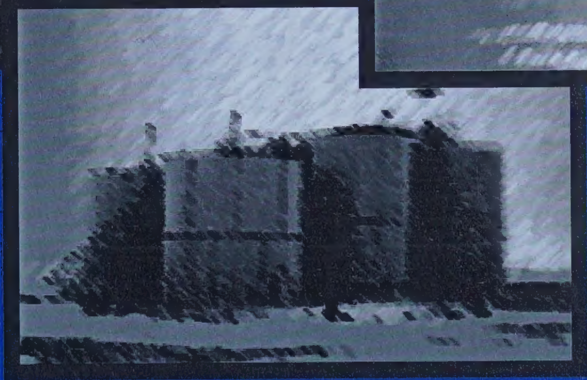
TexAlta Petroleum Ltd





2004 Annual Report

Table of Contents

Corporate Profile

Texalta Petroleum Ltd. is an emerging junior oil and gas company with a balanced program of exploration and development drilling. Our inventory includes producing properties in southeastern Saskatchewan, several prospect areas in central and southern Alberta, and pending exploration permits in the Northern Territory of Australia covering 5 million acres of land.

Texalta was incorporated in 1987 and began trading on the Alberta Stock Exchange in 1989. Texalta now trades on the TSX Venture Exchange under the symbol TEX.A.

Annual Meeting

The Annual Meeting of Shareholders will be held on:

Date: Tuesday,January 04, 2005

Time: 3:00 P.M.

Location: Ramada Hotel
Okanogan West Room
708 – 8 Avenue S.W.
Calgary, Alberta.

President's Message

November 16, 2004

Texalta Petroleum Ltd. is pleased to present its Annual Report, which includes the Management Discussion and Analysis and financial results for the year ending June 30, 2004.

The highlights of the past year included further land acquisition in areas of interest in Saskatchewan, an extensive seismic study defining new areas of interest, and the addition of three horizontal wells in the West Queensdale area during a time of favorable oil prices.

The northern half of the West Queensdale pool will be the focus of the Company's main exploratory efforts in the immediate future.

This area is largely undeveloped and is a prime candidate for the efficient use of modern horizontal drilling technology.

A recent study by Saskatchewan Industry and Resources has stated that a typical horizontal well in this region can be expected to produce two to three times that of a typical vertical well and do it much faster.

Considering that the southern half of the pool has recovered over 5 million barrels of oil from vertical wells since the original discovery, we are optimistic that significant additional reserves can effectively be produced from the northern area.

In Australia we continued negotiating with the Central Land Council regarding the Exploration Permits in the Georgina Basin. We are encouraged by the fact that a U.S. Company has entered into a satisfactory agreement with the Northern Land Council with respect to an area north of the Georgina Basin in the Northern Territory. We are optimistic that the Central Land Council will regard this agreement as a template for future agreements.

If you have any questions regarding this report, please feel free to contact the undersigned.

Yours truly,

TEXALTA PETROLEUM LTD.

William H. Nixon

William H. Nixon

President

Management Discussion & Analysis
Year Ending June 30, 2004

Basis Of Presentation

The following discussion is management's analysis of the operating and financial data for the year ended June 30, 2004 and equivalent period in the prior year for comparison of Texalta Petroleum Ltd. ("Texalta" or the "Company"). The discussion also includes estimates of future operating and financial performance based on information currently available. It should be read in conjunction with the audited financial statements and notes for the year ended June 30, 2004. This MD&A was prepared as of November 16, 2004.

To view the company's public documents please visit www.sedar.com.

Caution Regarding Forward-Looking Statements

From time to time, we make written and oral forward-looking statements within the meaning of certain securities laws, included in this Annual Report, in other filings with Canadian Securities regulators and Exchange Commission, in reports to shareholders and in other communications.

These forward-looking statements include, among others, statements with respect to our objectives, and the medium and long terms, and strategies to achieve those objectives, as well as statements with respect to our beliefs, plans, expectations, anticipations, estimates and intentions. The words "may," "could," "should," "would," "suspect," "outlook," "believe," "anticipate," "estimate," "expect," "intend," "plan," and words and expressions of similar import are intended to identify forward-looking statements.

By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution readers not to place undue reliance on these statements as a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements. These factors include, but are not limited to, the risks associated with oil and gas exploration, production, marketing, transportation, market fluctuations, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers and ability to access sufficient capital from internal and external sources and our anticipation of and success in managing the risks implied by the foregoing. As a consequence of the foregoing, actual results may differ materially from those anticipated in the forward-looking statements.

We caution that the foregoing list of important factors is not exhaustive. When relying on our forward-looking statements to make decisions, investors and others should carefully consider the foregoing factors and other uncertainties and potential events.

Management Discussion & Analysis
Overview of the Year Ending June 30, 2004

Texalta has had a busy year in southeast Saskatchewan where the Company has been prospecting and developing several areas of interest.

During this fiscal year the focus of Texalta's exploration and development has been in the Queensdale and West Queensdale areas of southeast Saskatchewan. During this 12-month period the company participated in 3 successful horizontal wells. Texalta has an 18.33% working interest in the first horizontal well spudded in July 2003, a 16.497% working interest in the horizontal well spudded in December 2003 and a 44.45% working interest in the horizontal well spudded in June 2004.

The most important area for the company is the West Queensdale property where the Company now has working interests in four producing horizontal wells and seven vertical wells.

Prior to the addition of the above mentioned horizontal wells, the volume of gas produced from the Queensdale wells was insignificant and was being flared. Presently about 150 mcf/d of associated gas is being flared at the Queensdale plant, a volume that will increase with further horizontal and vertical drilling. The Operating Company has now entered into a contract to connect to a sales line along which the gas will be transported and sold to a nearby facility.

In the past year at West Queensdale 480 acres of P&NG Leases have been added to the land picture and more land acquisition is planned at West Queensdale. New prospective acreage has also been acquired in the Wauchope area, northeast of Queensdale, where 640 acres of freehold lands have been acquired and Crown lands posted for sale in 2005. The Company plans call for even further expansion of our land position in the area.

During this reporting period, in an attempt to more clearly define areas of interest for future projects in the greater Queensdale / Arcola area, Texalta participated in a thorough seismic study. The subject area, covering the north half of township 6, range 2, W2, is an area of about 12,000 acres that contains the West Queensdale and Wildwood pools which have recovered about 6 ½ million barrels of oil. According to our studies, the potential for significant new oil discovery in the area is good.

The Texalta group now has over 70 km of modern multifold seismic data that is both proprietary and public. The Company has been building this seismic data bank since its predecessor company, Texalta Resources, drilled the first well in the Queensdale area in 1983.

Management Discussion & Analysis
Overview of the Year Ending June 30, 2004

As a result of this year's seismic and geologic study the company has acquired three new drillable prospects in proximity to our existing production facilities, any one of which could greatly improve shareholder value with success. Current plans call for the first of these prospects to be drilled in the first quarter of 2005.

Effective January 1, 2004, Texalta sold it's 17.55% working interest in 2,080 acres and three horizontal wells at Carlyle, Saskatchewan to the Operator for a consideration of $81,023. The Company has retained its 58.50% working interest in the rights below the Mississippian Formation under a Trust Agreement with the Operator. The Company intends to farmout the deeper rights at a future date.

Effective May 1, 2004, Texalta sold its 60% working interest in a 640 acre lease in the Joarcam, Alberta area to a third party for a consideration of $30,000. The Company retained the deeper rights and as such, entered into a Trust Agreement with the third party, which will hold Texalta's 60 % working interest in the deeper rights.

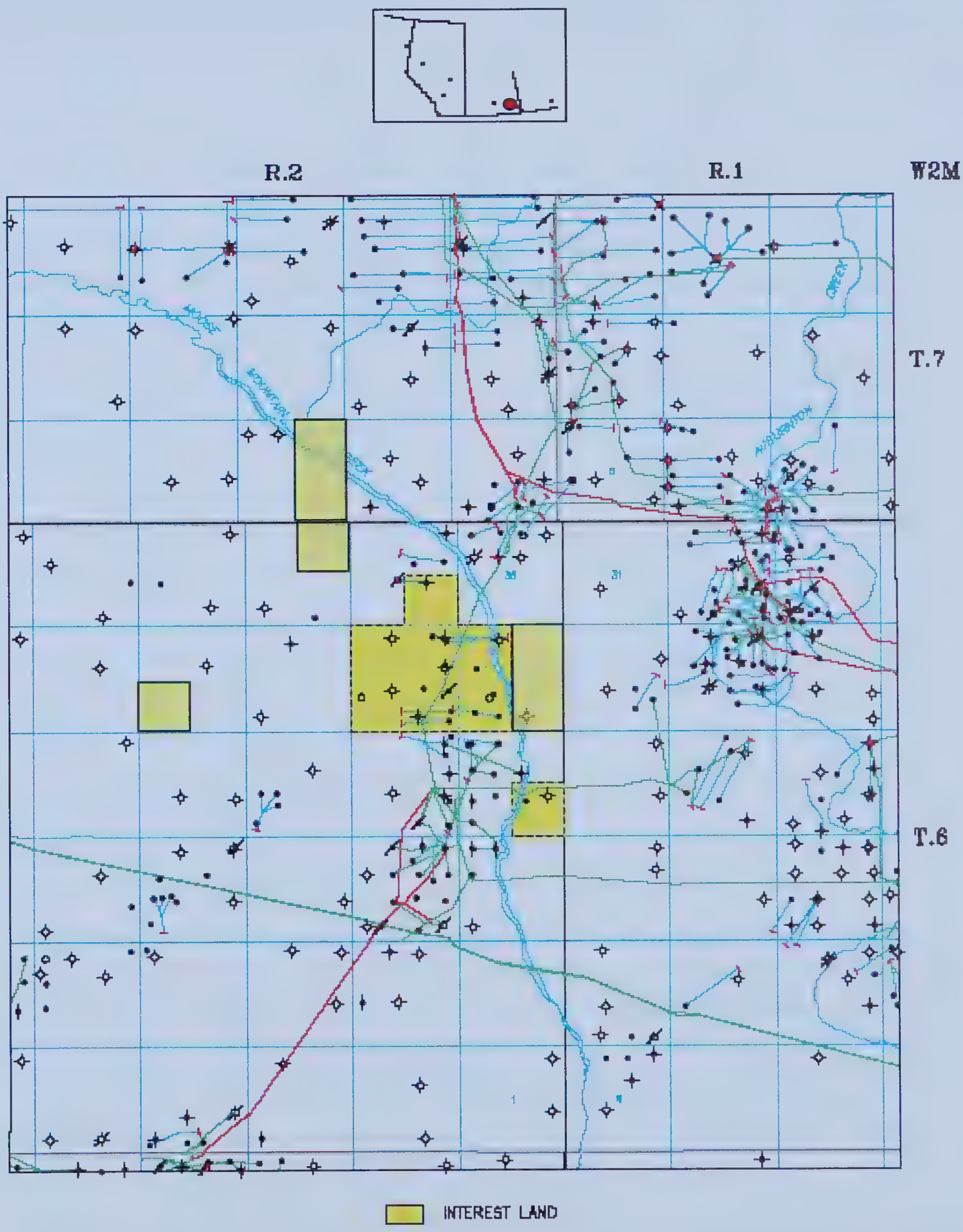
The consideration from the two above noted sales were allocated for the ongoing exploration and development of the Queensdale and West Queensdale areas.

Subsequent to June 30, 2004, a vertical well was drilled to the west of the main group of Queensdale / West Queensdale wells. Upon testing the well it was determined that the water cut was approximately 99%. While recovery of a small volume of oil was possible, the additional costs associated with processing large amounts of water and the completion of a flow line to the plant made it unfeasible for production. The well is slated for abandonment and the Company feels the results of the drilling indicate that oil reserves in the southwestern part of the project area have been depleted.

In Australia, the company continues to experience delays in attempting to make a suitable arrangement with lawyers acting on behalf of the Aboriginal community who have surface rights over part of the permit areas under application by Texalta and partners. Other companies operating in the central part of onshore Australia have experienced similar problems. Recent trends have indicated that some operators have arranged acceptable terms for surface access, therefore Texalta and partners are hopeful that a reasonable settlement can be reached and preliminary exploratory work can start on the permits. The Permits are scheduled for a 5-year term.

The year ahead should bring the Company closer to its goal of fully developing the potential in the southeastern Saskatchewan project areas as well as seeing agreement reached in our Australian Permits.

West Queensdale Area, Saskatchewan



Management Discussion & Analysis
Year Ending June 30, 2004

	Increase (-Decrease)	Year Ended June 30 2004		Year Ended June 30 2003	
Total Production	2%	17,264 bbls		16,958 bbls	
Average Barrels Per Day	7%	47 bbl/d		44 bbl/d	
Oil Revenue	24%	$	672,187	$	541,690
Royalties	0%		(96,853)		(96,647)
Operating Expenses	-3%		(128,101)		(131,611)
Netback	43%	$	447,233	$	313,432

Total oil sales for the year June 30, 2004 were $672,187 up 24% over $541,690 in 2003 reflecting new production from the HZ1D3 well that was placed on stream in late July 2003 and the HZ1A3 placed on production in late December 2003.

Oil prices were up to an average of $39 over the 12-month period ending June 30, 2004 compared to an average of $32 per barrel over the 12-month period ending June 30, 2003.

Total oil production for the year ended June 30, 2004 increased to 17,264 bbls, from 16,958 bbls in 2003. The Company produced an average of 47.2 bbls/d, an increase from an average 44 bbls/d in 2003.

The increase in volume over the previous year reflects the addition of 2 new horizontal wells. Subsequent to year end on July 6, 2004, the HZ4D1 well was placed on production. This new horizontal well has increased production by approximately 25 bbl/d.

During the year ending June 30, 2004 the Company paid $135,460 in royalty payments, an increase of $38,814 over the previous year however, the Company received a credit for overpayment of Alberta gas royalties which resulted in a reduction of $38,608 to the royalties paid .

Operating expenses for the year ended June 30, 2004 decreased slightly to $128,101 compared to $131,611 during 2003. The operations of our facilities and wells are closely monitored by the on-site operator. Regular maintenance and thorough inspections reduce the potential for costly repairs.

On a per barrel basis, operating expenses for 2004 decreased to $7.42 per bbl from $7.76 per bbl during 2003. This decrease is primarily due to the higher production while keeping operating cost relatively constant for both 2004 and 2003.

Capital Expenditures for the year ending June 30, 2004, were up 80% to $665,080 over $370,240 in 2003.

The expenditures relate to in-depth exploration via seismic study, land acquisition, drilling, completion, and tie ins of new production in the West Queensdale area.

General and administrative costs for the twelve months ended June 30, 2004 were up 22% to $190,815 from $155,899 for 2003.

The Company pays a flat monthly management fee of $7,000 to an affiliate which covers rent, parking, file storage, utilities, office supplies, office equipment, automobile usage/insurance, maintenance and general administrative services.

The CICA Accounting Standards Board has amended Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments to require entities to account for employee stock options using the fair value based method beginning January 1, 2004, and encouraged companies to adopt early in 2003. We have chosen to early adopt the fair value based method. Stock based compensation costs this year were $17,600.

The calculated depletion, amortization and accretion for the year ending June 30, 2004 was $256,682, down slightly from $262,801in 2003. This number was reduced in part by the addition of new reserves. The Company anticipates adding to the reserves by drilling new projects over the next 12 months, thus reducing the depletion further.

The Company had a working capital deficiency of $274,265 for 2004 compared to a positive working capital of $14,256 in 2003. The deficiency is for amounts cash called by the operating company in June 2004 for completion and tie in of the Petrex Texalta Queensdale W. HZ4D1-26/4D3-25-6-2W2M and amounts due to the affiliated company for management fees.

Corporate Governance

The responsibility of the Board of Directors of Texalta Petroleum is to manage or supervise the management of the business and affairs of the Company. The Board consists of three members, two of which are independent Directors.

The Board has established an Audit Committee to review and approve all financial statements, quarterly reports and other financial information that is publicly disseminated prior to release. The Audit Committee meets annually with the Corporation's external auditors with management present and may meet at any time throughout the rest of the year. The Audit Committee is responsible for reviewing management programs and policies regarding the adequacy and effectiveness of the internal controls over the accounting and financial reporting systems within the Corporation, including management's response to internal control recommendations of the external auditors.

The Board has established a Reserves Committee, which is responsible for reviewing the independent engineers' reserves report. Management has included the Reserves Committee in discussions between the Company and the independent engineers with respect to the reserves reports. The Reserves Committee also has direct access to the independent engineers.

The Board has established a Compliance Committee to manage the need to stay current with new securities rules and exchange policies with respect to public company compliance.

The Company has not established a Compensation Committee at this time.

Item 4.2 NI 51-101F1

RECONCILIATION OF CHANGES IN NET PRESENT VALUES OF FUTURE NET REVENUE DISCOUNTED AT 10%

TOTAL PROVED RESERVES CONSTANT PRICES AND COSTS

Period and Factor	After Tax 2003-2004 (M$)	Before Tax 2003-2004 (M$)
Estimated Net Present Value at June 30, 2003	**842**	**1,037**
	-	-
Estimated Net Present Value at June 30, 2003	**842**	**1,037**
Oil and Gas Sales During the Period Net of Production Costs and Royalties (1)	(447)	(447)
Changes due to Prices, Production Costs and Royalties Related to Forecast Production (2)	-	-
Development Costs During the Period (3)	486	486
Changes In Forecast Development Costs (4)	(486)	(486)
Changes Resulting from Extensions and Improved Recovery (5)	549	549
Changes Resulting from Discoveries (5)	-	-
Changes Resulting from Acquisitions of Reserves (5)	-	-
Changes Resulting from Dispositions of Reserves (5)	-	-
Accretion of Discount (6)	104	104
Net Change in Income Taxes (7)	(78)	
Changes Resulting from Technical Reserves Revisions	81	81
All Other Changes	67	88
Estimated Net Present Value at End of Period	**1,118**	**1,412**

(1) Company actual before income taxes, excluding G&A.
(2) The impact of changes in prices and other economic factors on future net revenue.
(3) Actual capital expenditures relating to the exploration, development and production of oil and gas reserves.
(4) The change in forecast development costs for the properties evaluated at the beginning of the period.
(5) End of period net present value of the related reserves.
(6) Estimated as 10% of the beginning of period net present value.
(7) The difference between forecast income taxes at beginning of period and the actual taxes for the period plus forecast income taxes at the end of period.

Note: Table prepared by TEXALTA and Gilbert Laustsen Jung Associates Ltd.

Georgina Basin, Australia

Texalta and its Australian partners have applied for two Exploration Permits (EPA's 103 & 104) in the Georgina Basin area of the Northern Territory. These two permits comprise some 23,376 square kilometers or about 5.5 million acres. Texalta has a 50% working interest in this project and initially is the operating partner.

Granting of the two permits continues to be in abeyance pending an agreement being reached with the local Aboriginal community (as represented by the Central Land Council). Texalta's Australian partners have been in contact with the lawyer representing the CLC, and efforts are ongoing to arrive at an agreement at which time it is anticipated that the permits will be formally granted and work can proceed in accordance with the requirements of each permit. Texalta and partners are enthused about the large scale potential of regional play that gains importance as more infrastructure is instituted and planned in this part of Australia.

The permits which cover part of this large basin area is attractive for petroleum and natural gas exploration as indicated by preliminary exploratory work carried out by both conventional oil exploration companies and by both the Federal and Northern Territorial governments. All the geologic data from their work is available to the Texalta partnership. This work includes geologic data from 20 stratigraphic tests, 8 deep wildcat wells and over 700 kilometers of modern seismic data.

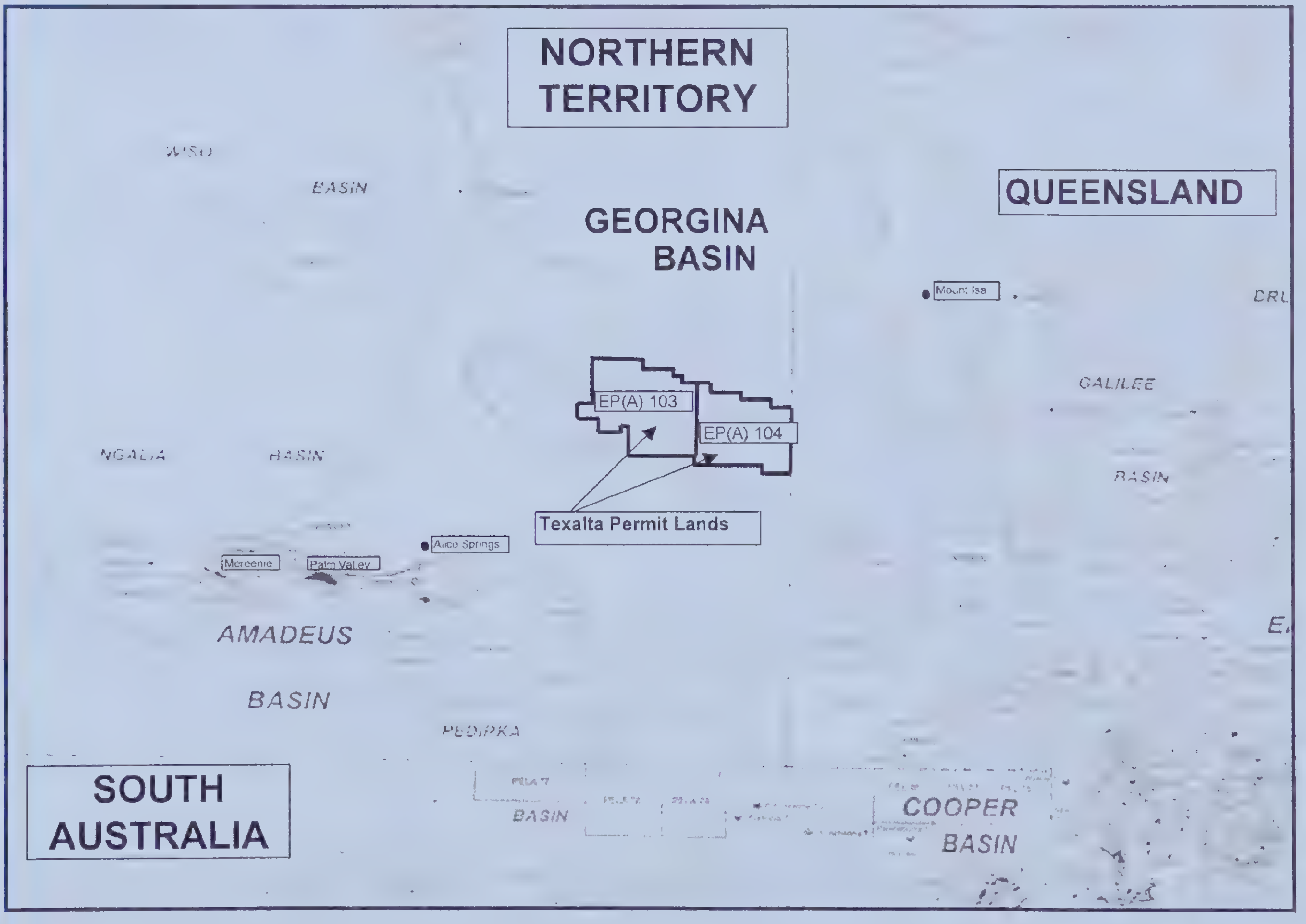
The Georgina Basin sedimentary area is located in the north-central part of Australia in both Western Queensland and the eastern part of the Northern Territory. The southern side of the Basin area, which straddles the Queensland and Northern Territory border, is the most prospective for petroleum. It contains two of these areas or depocenters, which have over 15,000 feet of sediment in the deepest part. The two trough-like areas include the Toko Syncline in the east and the Dulcie Syncline in the west. Geochemical studies of well information and outcrop samples have shown that the Dulcie Syncline region is oil-prone, while the deeper Toko Syncline is a gas-prone region.

The southern prospective area of the Georgina Basin extends about 600 kilometers, and is approximately two-thirds located in the Northern Territory and the remaining southeastern area in western Queensland. The widest part of the south basinal area measures about 200 kilometers across.

In this large region, the oil industry and the federal and Northern Territory governments have drilled about 22 wildcat wells. In addition, a large number of stratigraphic tests have been drilled over a four decade period beginning in 1962. This drilling activity, coupled with some regional seismic work and significant geologic work, has provided a definition of an attractive, underdeveloped oil exploration region.

The region bears a striking similarity to the productive geology of the north-east part of the Williston Basin in North America, although the prospective sequence is somewhat older in the Georgina. In particular, the oil-prone Dulcie Syncline area is similar to the Weyburn / Steelman / Carnduff region in southeast Saskatchewan where industry has discovered many oil fields in the 40 to 60 million barrels range.

On the other hand, the gas-prone, deeper faulted structural area of the Toko Syncline is more similar to the foothills of the Rocky Mountains, where gas fields containing 1 trillion cubic feet are not uncommon.



PERMIT MAP

Auditor's Report

To the Shareholders
Texalta Petroleum Ltd.

We have audited the balance sheets of Texalta Petroleum Ltd. as at June 30, 2004 and 2003 and the statements of loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at June 30, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Lamb Hill & Lim LLP

Calgary, Alberta
October 19, 2004

CHARTERED ACCOUNTANTS

Texalta Petroleum Ltd.
Balance Sheets as at June 30

	2004	2003
		(Restated Note 2)
ASSETS		
CURRENT		
Cash	$ 47,768	$ 50,529
Accounts receivable – Note 5	30,979	60,339
Income taxes receivable	-	36,000
ARTC receivable	-	4,800
	78,747	151,668
PROPERTY AND EQUIPMENT – Note 4	1,398,668	1,090,043
TOTAL ASSETS	$ 1,477,415	$ 1,241,711
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities – Note 5	$ 353,012	$ 137,412
LONG TERM		
Asset retirement obligation – Note 3	76,478	65,478
Future income taxes – Note 7	233,882	224,222
	310,360	289,700
SHAREHOLDERS' EQUITY		
Share Capital – Note 6	1,505,818	1,513,182
Contributed surplus – Note 6	15,387	-
Deficit	(707,162)	(698,583)
	814,043	814,599
TOTAL LIABILITIES AND EQUITY	$ 1,477,415	$ 1,241,711

Approved by the Board

Director

Director

Texalta Petroleum Ltd.
Statements of Loss and Deficit
For the Year Ended June 30

	2004	2003
		(Restated Note 3)
REVENUE		
Oil and gas sales	$ 672,187	$ 541,690
Less: royalties	(96,853)	(96,647)
Alberta Royalty Tax Credit	(4,800)	4,800
Royalty income	11,843	15,342
Other income	132	6,980
	582,509	472,165
EXPENSES		
Operating	128,101	131,611
General and administrative	190,815	155,899
Depletion, amortization and accretion	256,682	262,801
	575,598	550,311
Income (loss) before other item	6,911	(78,146)
Gain on sale of property and equipment	-	1,934
Income (loss) before income taxes	6,911	(76,212)
Income taxes		
Current income taxes (recovery)	5,830	(38,327)
Future income taxes	9,660	22,659
	15,490	(15,668)
Net loss	(8,579)	(60,544)
Deficit – Beginning of year	(698,583)	(638,039)
Deficit – End of year	$ (707,162)	$ (698,583)
Loss per share – Note 7		
Basic	$ -	$ -
Diluted	$ -	$ -

Texalta Petroleum Ltd.
Statement of Cash Flows
For the Years Ended June 30

	2004	2003
		(Restated Note 3)
OPERATING ACTIVITIES		
Net loss	$ (8,579)	$ (60,544)
Add items not requiring an outlay of cash		
Depletion, amortization and accretion	256,682	262,801
Gain on sale of property and equipment	-	(1,934)
Stock option expense	17,600	-
Future income taxes	9,660	22,659
Cash flow from operations	275,363	222,982
Net changes in non-cash working capital balances		
Accounts receivable	29,360	48,524
ARTC receivable	4,800	-
Income taxes receivable	36,000	(36,000)
Income taxes payable	-	(25,409)
Accounts payable and accrued liabilities	215,600	(128,679)
	561,123	81,418
FINANCING ACTIVITIES		
Issuance of share capital – net of costs	-	35,134
Normal course issuer bids	(9,577)	(10,150)
	(9,577)	24,984
INVESTING ACTIVITIES		
Acquisition of property and equipment	(665,080)	(370,240)
Proceeds on disposal of property and equipment	110,773	243,293
Capital lease obligation repayments	-	(39,878)
	(554,307)	(166,825)
Net cash flow	(2,761)	(60,423)
Cash – Beginning of year	50,529	110,952
Cash - End of year	**$ 47,768**	**$ 50,529**
Supplemental Information		
Interest paid	$ -	$ 1,107
Income taxes recovered	$ (29,402)	$ (7,327)

NOTE 1 COMPANY ACTIVITIES

The Company's activities are the exploration for, development of and production of oil and gas properties in Western Canada

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES

The financial statements of the Company have been prepared in accordance with generally accepted accounting principles consistently applied. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of financial statements for the year necessarily involves the use of estimates and approximations which have been made using careful judgment. The financial statements, have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below:

a) Property and equipment

The Company follows the full cost method of accounting whereby all costs related to the exploration for and the development of oil and gas reserves are initially capitalized. Costs capitalized include land acquisitions costs, geological and geophysical expenditures, costs of drilling productive and non-productive wells, together with overhead and interest directly related to exploration and development activities and lease and well equipment. Gains or losses are not recognized upon disposition of oil and natural gas properties unless such a disposition would significantly alter the rate of depletion and amortization.

Depletion of oil and gas properties is calculated using the unit of production method which is based upon gross proven reserves volumes. Gas volumes are converted to equivalent oil volumes based upon the relative energy content of six thousand cubic feet of gas to one barrel of oil.

The costs of acquisition and evaluation of unproved properties are initially excluded from the depletion calculation. These properties are assessed to determine whether an impairment in value has occurred. When proven reserves are assigned to the property or the property is considered to have an impairment in value the cost of the property or amount of the impairment value is added to the capitalized costs for the calculation of depletion.

The Company applies an impairment test ("ceiling test") to determine if capitalized costs are not recoverable and are greater than their fair value. Capitalized costs are not recoverable if they exceed estimated undiscounted cash flows from future production of proved reserves plus cost (net of impairment) of unproved properties. Cash inflows and costs are estimated using reserves data determined by independent engineers. Costs are based on expected future production and other costs and include asset retirement obligations. An impairment loss is recognized if capitalized costs are greater than their recoverable amount. The impairment loss is measured as the amount by which the capitalized costs exceed the fair value of proved and probable reserves plus the cost (net of impairment) of unproved properties.

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

b) Full-Cost Accounting

In 2003, the CICA issued Accounting Guideline 16, Oil and Gas Accounting – Full Cost (AcG-16). The guideline is effective for fiscal years beginning on or after January 1, 2004. The new guideline modifies the ceiling test calculation applied by the Company. The ceiling test was changed to a two-stage process which is to be performed at least annually. The first stage of the test is a recognition test which compares the undiscounted future cash flow from proved reserves to the net book value of the petroleum and natural gas assets to determine if the assets are impaired. An impairment loss exists when the carrying amount of the petroleum and natural gas assets exceeds such undiscounted cash flow. The second stage determines the amount of the impairment loss to be recorded. The impairment is measured as the amount by which the net book value of the petroleum and natural gas assets exceeds the future discounted cash flow from proved plus probable reserves. The adoption of this guideline in 2004 did not have an impact on the financial results of the Company.

c) Asset Retirement Obligations

Effective July 1, 2003, the Company adopted the CICA Handbook Section 3110, "Asset Retirement Obligations." This section requires recognition of a liability at discounted fair value for the future abandonment and reclamation associated with the petroleum and natural gas properties. The fair value of the liability is capitalized as part of the cost of the related asset and amortized to expense over its useful life. The liability accretes until the date of expected settlement of the retirement obligations. The related accretion expense is recognized in the statement of operations. The provision will be revised for any changes to timing related to cash flow or undiscounted abandonment costs. Actual expenditures incurred for the purpose of site reclamation are charged to the asset retirement obligations to the extent that the liability exists on the balance sheet. Differences between the actual costs incurred and the fair value of the liability recorded are recognized to earnings in the period incurred.

The provisions of this section require that the standard be applied retroactively with restatement of comparative periods. As a result of this change, net loss for the year ended June 30, 2003 decreased by $1,883. At June 30, 2003 the asset retirement obligations balance increased by $20,406 to $65,478, the property and equipment balance increased by $44,072. The opening 2003 accumulated deficit increased by $5,965. There was no impact on cash flow as a result of adopting this policy.

d) Revenue Recognition

Revenue associated with the sales of petroleum and natural gas production owned by the Company is recognized when the title passes from the Company to its customers.

e) Joint Venture Accounting

Substantially all of the exploration and production activities of the Company are conducted jointly with others and accordingly these accounts reflect only the Company's proportionate interest in these activities.

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

f) Amortization

Amortization is provided on the estimated useful life of the production equipment using the straight-line method at 15% per annum. Amortization is provided on the estimated useful life of the other assets using the declining balance method at 30% per annum.

g) Flow-through Shares

Share capital includes flow-through shares issued pursuant to certain provisions of the Income Tax Act (Canada). The Act provides that, where the share issuance proceeds are used for exploration and development expenditures, the related income tax deductions may be renounced to subscribers. Accordingly, share capital is reduced and future tax liability is recorded equal to the estimated amount of future income taxes payable by the Company as a result of the renunciations, when the expenditures are made.

h) Stock-based Compensations Plans

Effective July 1, 2003, the Company adopted the recommendations of CICA Handbook Section 3870, "Stock Based Compensation and Other Stock-Based Payments". This section required that direct awards of stock and liabilities based on the price of common stock be measured at fair value at each reporting date, with the change in fair value reported in the statements of income and encourages, but does not require, the use of the fair value method for all other types of stock-based compensation plans. The Company's plan does not qualify as direct awards of stock or as a plan that creates liabilities based on the price of the Company's stock, and as a result, the implementation of the section had no impact on the financial statements. In 2003, the Company had chosen not to use the fair value method to account for its stock-based employee compensation plan, but to disclose pro-forma information for options granted after July 1, 2002.

The recommendations of the CICA Handbook Section 3870 "Stock Based Compensation and Other Stock-Based Payments" were amended in September 2003 to require the expensing of all stock based compensation awards for fiscal years beginning after January 1, 2004. The Company has chosen to early adopt the recommendations under the transitional rules thereby recording the fair value of the stock options since July 1, 2003 in the statement of operations. Pro-forma disclosures for stock based compensation expense have been determined using the Black-Scholes option-pricing model.

i) Income Taxes

Income taxes are calculated using the liability method of tax allocation accounting. Temporary differences arising from the difference between the tax basis of an asset or liability and its carrying amount on the balance sheet are used to calculate future income tax liabilities or assets. Future income tax liabilities or assets are calculated using tax rates anticipated to apply in the periods that the temporary differences are expected to reverse. Temporary differences arising on business combinations may result in future income tax liabilities or assets being recognized on acquisition.

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

j) Measurement Uncertainty

The amounts recorded for depletion of property and equipment and the asset retirement costs are based on estimates. The ceiling test calculation is based on estimates of proven reserves, production rates, petroleum and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect of any changes in such estimates on the financial statements of future periods could be material.

k) Per Share Amounts

Basic earnings per share is computed by dividing earnings by the weighted average number of Class A shares outstanding during the year. Diluted per share amounts reflect the potential dilution that could occur if stock options or warrants to purchase common shares were exercised and converted to common shares. The treasury stock method of calculating diluted per share amounts is used whereby any proceeds from the exercise of stock options or warrants are assumed to be used to purchase common shares of the Company at the average market price during the year.

NOTE 3 ASSET RETIREMENT OBLIGATIONS

	2004	2003
Balance, beginning of year	$ 65,478	$ 46,135
Liabilities incurred	8,113	16,225
Accretion	2,887	3,118
Balance, end of year	$ 76,478	$ 65,478

NOTE 4 PROPERTY AND EQUIPMENT

	2004	2003
Petroleum and natural gas properties	$3,155,706	$2,645,994
Asset retirement obligation	52,232	44,119
	3,207,938	2,690,113
Less: Accumulated depletion	(1,936,970)	(1,705,710)
	1,270,968	984,403
Lease and well equipment	271,433	226,838
Less: Accumulated amortization	(143,733)	(121,198)
	127,700	105,640
	$1,398,668	$1,090,043

NOTE 4 PROPERTY AND EQUIPMENT – CONTINUED

Costs of unproven petroleum and natural gas properties amounting to $61,122 (2003 - $51,179) have been excluded from the depletion calculation.

At June 30, 2004 and 2003, the cost ceiling exceeded the capital cost of the Company's petroleum and natural gas properties and a write-down was not required.

The price used in the impairment test at June 30, 2004 was $43.21 Cdn per Barrel.

No general and administration costs were capitalized during the years ended June 30, 2004 and 2003.

NOTE 5 RELATED PARTY TRANSACTIONS

At June 30, 2004, $336,941 (2003 - $116,568) of amounts due to affiliates are included in accounts payable and accrued liabilities and $28,573 (2003 - $29,255) of amounts due from affiliates are included in accounts receivable.. The affiliate is a corporation controlled by an officer and director of the Company.

The following transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

a) The Company has a joint venture interest in certain properties, the operator of which is an affiliate. During the year the Company paid $625,323 (2003 - $100,690) to the affiliate in respect of its share of property expenditures. The Company recorded $393,394 (2003 - $188,434) from the affiliate in respect of its share of net revenues and gross overriding royalties.

b) The Company operates certain properties of which the affiliate is a joint venture partner. During the year, the Company paid $5,381 (2003 - $12,998) to the affiliate in respect of the affiliate's share of revenues, net of property and production expenditures.

c) Management fees were charged by the affiliate in the amount of $84,000 (2003 - $84,074). The management fee represents a reimbursement of salaries, rent and other administrative functions.

NOTE 6 SHARE CAPITAL

a) Authorized:
   Unlimited number of Class A common voting shares
   Unlimited number of Class B non-voting shares
   Unlimited number of Class C preferred, non-voting, non-cumulative shares

NOTE 6 SHARE CAPITAL – CONTINUED

b) Issued, Class A shares

	2004		2003	
	Number	Amount	Number	Amount
Balance, beginning of year	14,073,962	$ 1,513,182	13,993,962	$ 1,502,998
Issued for cash:				
Flow through shares (net of share issue cost of $1,661)	-	-	230,000	35,134
Shares repurchased and cancelled	-	-	(58,000)	(5,625)
Repurchased shares to be cancelled	(68,500)	(7,364)	(92,000)	(4,525)
Tax effect of flow through shares	-	-	-	(14,800)
Balance, end of year	14,005,462	$1,505,818	14,073,962	$1,513,182

c) During the year, pursuant to two normal course issuer bids effective December 10, 2002 and December 17, 2003, the Company repurchased 68,500 (2003 – 150,000) common shares at an average price of $0.14 (2003 - $0.07) per share after brokerage. The purchase price in excess of the average cost of $2,213 was charged to contributed surplus. As of year end, 68,500 of these shares are to be returned to treasury for cancellation.

d) During the year ended June 30, 2004, the Company issued NIL (2003 – 230,000) flow-through shares each with one share purchase warrant attached to it. These warrants can be exercised into one common share per warrant at any time up to July 10, 2003 at a price of $0.35. All warrants expired July 10, 2003.

e) The Company has established a Stock Option Plan for its directors, management and employees. At no time will more than 10% of the outstanding listed shares (on a non-diluted basis) be under option pursuant to the Plan. The number of Shares under Option at any specific time to any one Optionee shall not exceed 5% of the issued and outstanding common share capital of the Company (aggregate number of options to consultants not to exceed 1% of the issued and outstanding common shares).

f) In 2004, the Company adopted the fair value method of accounting for all stock-based payments to employees and directors. Under this method, the Company recognized $17,600 as stock based compensation cost and a related credit to contributed surplus. The fair value of the stock options granted was estimated at the date of grant using the Black-Scholes Pricing Model assuming a risk-free interest rate of 4.075%, dividend yield of 0% stock price volatility of 66% and an expected life of the options of 4 years.

A summary of the status of the equity incentive plan as at June 30, 2004 and 2003 and changes during the years then ended is presented below.

NOTE 6 SHARE CAPITAL – CONTINUED

	Options Outstanding	Range of Exercise Price	Weighted Average Exercise Price	Options Exercisable
Outstanding at June 30, 2002	451,910	$0.10 - $0.16	$0.11	451,910
Granted	903,090	$0.11	$0.11	903,090
Outstanding at June 30, 2003	1,355,000	$0.10 - $0.16	$0.11	1,355,000
Expired	(76,600)	$0.16		(76,600)
Cancelled on resignation of Director	(174,300)	$0.10 - $0.16		(174,300)
Granted	200,000	$0.165	$0.165	200,000
Outstanding at June 30, 2004	1,304,100			1,304,100

These options expire at various times to February 2008.

In 2003, had compensation expense been determined on the fair value at the grant dates, the loss per share would have been increased to the pro forma amounts in detail below:

Stock based compensation	$ 40,639
Net loss	
As reported (restated)	(60,544)
Pro forma	(101,183)
Net loss per share – basic and diluted	
As reported	$ -
Pro forma	$ (0.01)

The fair value of each option granted is estimated on the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

Fair value of options granted (per share)	$0.045
Risk-free interest rate (%)	4.297
Expected life (months)	48
Expected volatility (%)	46
Expected dividend yield (%)	0.00

g) The Company uses the treasury stock method of calculating per share amounts whereby the proceeds from exercise of stock options are assumed to purchase common shares at average market prices. The calculation of basic net loss per share is based on the weighted average number of common shares outstanding during the year ended June 30, 2004 of 14,069,006 (2003 – 14,154,874). No adjustments were required to reported earnings in computing diluted per share amounts.

NOTE 7 INCOME TAXES

a) Income taxes differ from the results which would be obtained by applying the combined federal and provincial income and rates of 45.08% (2002 – 40.08%) to loss before income taxes. The difference results from the following:

	2004	2003
Expected income tax (recovery)	$ 3,115	$ (31,980)
Increase (decrease) resulting from:		
Non-deductible crown payments	(5,717)	26,083
Resource allowance	(14,227)	(10,492)
2001 Refund not recorded	-	(7,327)
Other adjustments	11,697	16,858
	(5,132)	(6,858)
Increase (reduction) in future income taxes resulting from tax rate adjustment	20,622	(8,830)
	$ 15,490	$ (15,688)

b) The components of the future income tax liability at June 30 are as follows:

	2004	2003
Petroleum and natural gas properties and equipment	$ 286,135	$ 243,290
Asset retirement obligations	(34,476)	(18,065)
Federal loss carry forward	(15,966)	-
Other	(1,811)	(1,003)
	$ 233,882	$ 224,222

c) The company has available the following amounts which may be deducted at the annual rates indicated, on determining taxable income for future years:

	2004	2003	Rate
Canadian exploration expense	$ 85,399	$ -	100%
Canadian development expense	516,491	252,173	30%
Canadian oil and gas property expense	36,481	101,894	10%
Foreign exploration and development expense	12,397	13,774	10%
Undepreciated capital cost	113,173	98,869	15% - 30%
Cumulative eligible capital	2,347	2,524	7%

The Company has tax loss carryforwards available of $46,031 expiring in 2011.

NOTE 8 BANK INDEBTEDNESS

During the year the Company has negotiated a new credit facility. The facility is a demand revolving loan of $250,000 bearing interest of prime plus 1.5% and is secured by a fixed and floating charge debenture of $1,000,000 over certain assets of the Company. The demand revolving loan will be reduced at $17,000 per month.

NOTE 9 FINANCIAL INSTRUMENTS

a) Fair Value

Financial instruments consist mainly of cash, accounts receivable and accounts payable and accrued liabilities. The fair value of all financial instruments approximate to their carrying value.

b) Credit Risk

Receivables include amounts receivable for oil and gas sales which are generally made to credit worthy purchasers, therefore the Company views credit risk on these amounts as low.

NOTE 10 CONTINGENCIES

The Company commenced an action under The Builders' Lien Act of Saskatchewan related to three Claims of Lien under the Act against one of its properties. The Company has requested that all claims asserted under the Act be determined. The Company has had counterclaims filed by all three external parties involved requesting their liens under the Act be enforced. To date, no court date has been assigned and, in the opinion of management no estimate of potential loss can be made.

Texalta Petroleum Ltd.

8228 Elbow Drive S.W., Calgary, Alberta T2V 1K4
Telephone: (403) 255-8380 Facsimile: (403) 255-8007
Email: texalta@texalta.com

OFFICERS

William H. Nixon
President , CEO

Susan L. White
Secretary-Treasurer, CFO

DIRECTORS

William H. Nixon
Petroleum Geologist
President
Texalta Petroleum Ltd.
Calgary, AB

Dr. Peter A. Hiron
Physician
Sault Ste. Marie, ON

Ronald J. Kirschner
Consulting Engineer
Edmonton, AB

BANK

Canadian Western Bank, Calgary, Alberta

AUDITORS

Lamb Hind & Lim, LLP
Chartered Accountants, Calgary, AB

LEGAL COUNSEL

Morris S. McManus, Q.C., Calgary, AB

REGISTRAR & TRANSFER AGENTS

Computershare Trust Company of Canada, Calgary, AB

To access all of Texalta's public documents, please visit www.sedar.com